No. 22788

In the

United States Court of Appeals

For the Ninth Circuit

WHITE CHEMICAL COMPANY,

Appellant,

vs.

HENRY MORADIAN, RECEIVER IN BANKRUPTCY OF CAL-ZONA FARMS, A CORPORATION, AND HENRY MORADIAN, TRUSTEE IN BANKRUPTCY, ET AL,

Appellees.

Brief for Appellees

FENNEMORE, CRAIG, VON AMMON, McCLENNEN & UDALL

ROBERT H. CARLYN

411 North Central Avenue, Suite 900

Phoenix, Arizona 85004

Attorneys for appellee Southwest Forest Industries, Inc.

RAWLINS, ELLIS, BURRUS & KIEWIT

WILLIAM D. BAKER

733 Security Building

Phoenix, Arizona 85004

Attorneys for appellee Producers Cotton Oil Co.

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

SUBJECT INDEX

TABLE OF AUTHORITIES CITED

No. 22788

In the

United States Court of Appeals

For the Ninth Circuit

WHITE CHEMICAL COMPANY,

Appellant,

vs.

HENRY MORADIAN, RECEIVER IN BANKRUPTCY OF CAL-ZONA FARMS, A CORPORATION, AND HENRY MORADIAN, TRUSTEE IN BANKRUPTCY, ET AL,

Appellees.

Brief for Appellees

SUMMARY OF ARGUMENT

The District Court properly held that Receiver's Certificates should be accorded priority over other costs of administration incurred in a Chapter XI proceeding where the Certificates were validly issued pursuant to Section 344 of the Bankruptcy Act and they expressly provided for such priority. The granting of such priority to Receiver's Certificates is authorized by Section 344. That Section creates an exception to the parity treatment of costs of administration provided for by Section 64 a (1) of the Bankruptcy Act just as an exception is created for the payment of the costs of administration for a superseding bank-

ruptcy. However, even if the priority treatment accorded the Receiver's Certificates was not expressly authorized by statute, the Bankruptcy Court has equitable power to accord such priority to the Certificates.

The policy of Section 64a is in part to promote effective and efficient administration of estates under the jurisdiction of the Bankruptcy Court. The District Court's holding that the priority expressly granted the Receiver's Certificates should be respected and given effect is consistent with this policy. Unless the recipients of Receiver's Certificates can be assured that the priority granted in the Certificates will be respected, the availability of capital will be severely restricted and the likelihood of achieving the goal of the proceeding will similarly be impaired.

STATEMENT OF FACTS

On July 16, 1964, the debtor, Cal-Zona Farms, a corporation, filed a petition proposing an arrangement under the provisions of Chapter XI of the Bankruptcy Act, 11 U.S.C. Section 701 et seq. (R. 4)[1]

To obtain funds for the continuance of the debtor's business (R. 5), the Receiver filed, on or about July 28, 1964, his petition seeking authorization to issue to Producers Cotton Oil Company (hereinafter referred to as Producers), a Certificate of Indebtedness in the sum of $30,000. (R. 4-6). This petition was approved on or about July 28, 1964 (R. 7-9). On or about August 21, 1964, the Referee, upon petition of the Receiver (R. 10-16), issued his amended order authorizing the issuance of this Receiver's Certificate (R. 17-23).

---

1. The record in this case consists of a volume of court filings. The court filings are numbered consecutively so that an item on page 100 will be cited "R. 100".

Both the original Order and Certificate and the Amended Order and Amended Certificate of Indebtedness provided:

> . . . that the earnings, income, profits, property and estate of the . . . Debtor

were to be charged with the lien of the Certificate and that the Certificate was to have priority over the expenses of administration incurred therein (R. 8, 18 and 21). Based upon this priority position, Producers advanced new money to the Receiver to keep the debtor's business in operation, and there remains due, owing and unpaid thereon the sum of $16,777.85 (R. 143).

To obtain additional funds for the continuance of the debtor's business (R. 25, 34) which the Receiver was unable to secure from any other source (R. 36), and following a meeting of creditors of the debtor on September 16, 1964, the Referee approved an agreement whereby the Receiver was authorized and directed to issue his Certificate to Southwest Forest Industries, Inc. (hereinafter referred to as Southwest) for Fifty Thousand Dollars ($50,000) in exchange for a loan by Southwest in the same sum (R. 53-55). In that order, the Referee authorized and directed that the income and estate of the debtor be charged with the lien of the Certificate and the Certificate should have priority over the expenses of administration incurred therein (R. 54). Pursuant to that order, the Receiver issued his Certificate for Fifty Thousand Dollars ($50,000) to Southwest on or about October 26, 1964 (R. 59-60). There remains due, owing and unpaid on said Certificate the sum of $50,000 (R. 142).

The Referee, upon the hearing regarding payment of these Certificates, concluded that the Certificates issued to Southwest and to Producers were validly issued as pro-

vided in Section 344 of the Bankruptcy Act, 11 U.S.C. § 744 (R. 146-147).

Beginning on August 1, 1964, White Chemical Company (White) and Seeds, Inc. furnished goods and services to the debtor in the amount of $28,451.28 and $3,718.30, respectively (R. 61-62; 56-57). These goods and services were furnished at the request of the Receiver and were used by him in connection with the growing and harvesting of the 1964 fall lettuce crop. The Receiver did not issue a Certificate of Indebtedness to White or Seeds, Inc., nor was he authorized to do so by the Referee. All of these goods and services were furnished by White and Seeds, Inc. during the Chapter XI proceeding (R. 143-144). The goods and services furnished by White and Seeds, Inc. to the debtor did not materially benefit or enrich the debtor's estate or its creditors (R. 145).

On December 29, 1964, the Referee entered an order adjudging the debtor a bankrupt and directing that bankruptcy be proceeded with pursuant to the provisions of the Bankruptcy Act (R. 110). The funds presently held by the trustee are comprised in toto of the proceeds of sale of assets of the bankrupt and the proceeds received by the trustee from the settlement of a civil action and a turnover order, and none of these funds represent any income from crops grown by the receiver or the trustee (R. 145).

On September 27, 1967, the Referee entered an order providing that the assets of the bankrupt's estate be distributed in the following order of priority:

1. Payment of the reasonable fees and expenses of the trustee, trustee's attorney, accountant, bankrupt's attorney, receiver and receiver's attorney.

2. Payment in full of the Certificate of Indebtedness held by Southwest and Producers Cotton Oil Company. If

sufficient funds were not available to pay such Certificates in full, then they were to participate in the available funds on a pro rata basis.

3. Payment of the claims of White and Seeds, Inc. as administrative expenses of the Chapter XI proceeding (R. 139-148).

On or about October 6, 1967, White filed its petition for review of the Referee's order in the United States District Court for the District of Arizona (R. 150-164). In its petition for review, White contended that the Referee's order was erroneous because it provided for priorities not authorized under Section 64a(1) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1) (R. 169). White contended that all costs of administration of the Chapter XI proceeding must be treated on a parity in the distribution of the estate on a pro rata basis after the payment of the costs of administration of the superseding bankruptcy proceeding since all those costs are accorded a first priority status (R. 176).

The District Court, William P. Copple, District Judge, rejected this contention and, on January 30, 1968, entered its opinion and order holding that Section 344 of the Bankruptcy Act provides an exception to the general rule of parity distributions and allows for special treatment of receiver's Certificates of Indebtedness (R. 199-200). The Court held that the priority given the Certificates of Indebtedness was fully within the authority of the Referee under Section 344 but that the Referee erred in his final order of distribution in withdrawing the priority accorded to the Certificates and refusing to allow the Certificates their assigned priority (R. 200-201). The Court held that the proper order of priorities was as follows:

(1) The costs of administration of the superseding bankruptcy proceeding including those fees of the bankrupt's attorney allocable to the bankruptcy proceedings.

(2) Payment of the balance due on the Certicates of Indebtedness owned by Southwest and Producers and if there were insufficient funds in the hands of the trustee to pay in full the balances due, then the holders of such Certificates were to share pro rata in the distribution of funds.

(3) The remaining costs of administration in the Chapter XI proceedings (R. 203).

The District Court remanded the case to the Referee for further findings of fact with respect to the services, if any, rendered by the bankrupt's attorney in the superseding bankruptcy since the Referee's findings failed to distinguish between the fees and expenses of the bankrupt's attorney rendered in the bankruptcy proceeding and in the superseded Chapter XI proceeding (R. 203-204).

It is this opinion and order which the appellant is questioning by this appeal (R. 207).

Subsequently, the bankrupt's attorney, by affidavit, stated that he performed no services and made no claim for compensation for the performance of any services in connection with the bankruptcy proceeding (R. 205).

The appellant concedes that it is bound by the facts as set forth above and contained in the Referee's findings of fact since they are not clearly erroneous (R. 212).

STATEMENT OF QUESTION PRESENTED

Whether Receiver's Certificates of Indebtedness which expressly provide for payment prior to other costs of administration and are validly issued pursuant to Section 344 of the Bankruptcy Act are to be accorded such priority over other costs of administration incurred in a Chapter XI proceeding.

ARGUMENT

The District Court Properly Accorded the Receiver's Certificates of Indebtedness Priority in Payment Over Other Expenses of Administration Incurred in the Chapter XI Proceeding.

As a preliminary matter, it should be noted that the question of the authority of the Referee under Section 64 a(1) of the Bankruptcy Act (11 U.S.C. § 104(a)(1)) to give priority to the costs of administration in the superseding bankruptcy proceedings over the costs of administration in the superseded Chapter XI proceedings is not in issue here (R. 207). This is especially significant since the cases cited by appellant are largely concerned with the relative priorities of costs of administration in a superseded Chapter XI proceeding and a superseding bankruptcy.

What is involved in this appeal is whether a Receiver's Certificate, validly issued under the provisions of Section 344 of the Bankruptcy Act (11 U.S.C. § 744) can include in its provisions a requirement that it be paid prior to the payment of any other costs of administration. It is the position of these appellees that such a provision is valid and when such a Certificate has been approved by the Referee upon the request of the Receiver and the attorney for the bankrupt, this priority is binding and the holders of these Certificates must be paid prior to payment of any other costs of administration of the superseded Chapter XI proceeding. To refuse to honor this priority after the holders of the Certificates rely thereon and advance new monies to the Receiver so that he can continue the business of the Debtor, would be to rewrite the agreement and, as a result, would seriously impair the use of such Certificates and could make any future Chapter XI proceedings doubtful as to their success.

Section 344 of the Bankruptcy Act (11 U.S.C. § 744) provides:

> During the pendency of a proceeding for an arrangement . . . the court may upon cause shown authorize the receiver or trustee, or the debtor in possession, to issue certificates of indebtedness for cash, property or other consideration approved by the court, upon such terms and conditions and with such security and priority in payment over existing obligations as in the particular case may be equitable.

Appellees have been unable to find any authority which holds or suggests that this section does not mean what it says. It provides that the Referee may authorize the issuance of receiver's Certificates of Indebtedness on such terms and conditions and with such priority as in the particular case may be equitable. This is precisely what the Referee did in this case when he authorized the Certificates to be issued with priority over other costs and expenses of administration in the Chapter XI proceedings.

The appellant contends that the court was precluded from according the receiver's Certificate such priority by virtue of Section 64 a (1) of the Act (11 U.S.C. § 104(a)(1)). Section 64 a (1) provides that the costs and expenses of administration of a superseded Chapter XI proceeding shall be entitled to a first priority in payment in the distribution of bankrupt estates subject to the payment of the costs and expenses of administration incurred in a bankruptcy superseding the Chapter XI proceeding.

The appellant contends that since all costs of administration in the superseded proceeding are entitled to a first priority then the court is without authority to recognize and effect the express priority accorded a Receiver's Certificate in the superseded proceeding because that would in effect create a sub-priority which appellant contends is prohibited by the language of the statute (Appellant's Opening Brief at 11-12).

The appellant cites and quotes at length from *In re Columbia Ribbon Co.,* 117 F.2d 999 (3rd Cir. 1941) (Appellant's Opening Brief, p. 13). The appellant apparently relies upon that case for the proposition that the court may not under any circumstances grant a priority to one cost of administration in a superseded Chapter XI proceeding over other costs of administration incurred in the same proceeding. Although appellant asserts that that case is relevant to the instant case, the decision suggests, indeed compels, an opposite conclusion. In that case, the court was not concerned with the relative priorities of costs of administration in a superseded Chapter XI proceeding. To the contrary, the court was concerned with and considered the relative priorities as between costs of administration in a superseded Chapter X proceeding and costs in a superseding bankruptcy.

The appellant's reliance upon *Home Indemnity Company v. F. H. Donovan Painting Co.,* 325 F.2d 870 (8th Cir. 1963) is not well founded. In that case, the questions presented were whether sums paid as wages by the appellant surety between the date of contractual default by the bankrupt and the date of its bankruptcy constituted wages within the meaning of Section 64 a (2) of the Bankruptcy Act requiring allowance as a wage priority claim; and whether a wage priority claim allowed for wages due prior to the bankrupt's default was properly subordinated to the payment of a tax claim of the United States and the State of Texas. The court found that the wages paid after the bankrupt's default were not paid to its employees but rather to the employees of the surety company and accordingly they were not entitled to a wage claim priority. The court observed that under Section 64 wage claims were entitled to a second priority while tax claims were entitled to a fourth priority and that:

> . . . by act of Congress, surety's $17,974.25 claim would have priority were it not for the equitable power of a Federal Bankruptcy Court to subordinate claims of some creditors to those of others. According to controlling equitable principles, a surety may not share in a bankrupt's assets ahead of or on equal terms with any creditors who are members of the class the surety's bond had been given to protect. (citations omitted) Application of this rule to the claims before us necessitate subordination of surety's wage claim to the tax claim of the State of Texas and to that portion of the tax claim of the United States that arose in the course of the Ford Hood project.
>
> 325 F.2d 874, 875.

The *Donovan* case clearly did not involve the questions of priorities presented in the instant case. Accordingly, it does not govern the decision here. To the extent that it can be considered relevant to the question presented, it does not support the appellant's position since the court clearly recognized that "the act does not establish inexorable rules for distribution which can never be deviated from in the interests of justice and equity." 325 F.2d at 876.

Similarly, in *In re Delaware Hosiery Mills,* 202 F.2d 951 (3rd Cir. 1953) the Court did not consider the respective priorities of Receiver's Certificates and other costs of administration in a Chapter XI proceeding. Receiver's Certificates were not even involved in that case. That alone would distinguish the *In re Delaware* case. However, it is difficult to understand in what way that case supports the petitioner's contentions, especially in view of the court's comments:

> Of course, it may be possible for the receivers' Certificate on the authorization of the court to provide terms for priority or subordination of the loan—gen-

> erally provision is made either for parity with other expenses of administration or subordination to same.
>
> There was no express provision in the authorization given by the District Court in the instant case as to the order of priority of the borrowed money with respect to the other costs of administration and we will not construe the language of the decree as giving the creditor any such priority.
>
> 202 F.2d at 953

The above quoted portion of the court's opinion amply demonstrates that the "Certificates" simply did not provide for priority as they did in the instant case. Had they done so, the court's opinion suggests that such a priority would have been respected. Accordingly, that case does not support the appellant's assertions but rather it strongly suggests a position contrary to that of the appellant's.

Similarly, *Miller v. Sulmeyer,* 299 F.2d 102 (9th Cir. 1962) did not involve the question of the priorities presented in the instant case. In that case, a mortgage was partially invalid under state law because of delay in recordation and the mortgagees contended that under equitable principles the referee should have subordinated claims of those creditors to whom the mortgage was valid. The referee denied the mortgagees' request for subordination and held that they should participate in dividends in the same manner as other unsecured creditors. On appeal, this Court considered the sole question to be:

> After the doctrine of *Moore v. Bay,* supra, has been invoked to invalidate a mortgage only partially invalid under state law, can the mortgagee obtain a subordination of the claims of creditors as to whom the mortgage was valid outside of bankruptcy, by appealing to the equitable powers of the bankruptcy court?
>
> 299 F.2d at 103-104

This court concluded that *Moore v. Bay* was controlling and the appellants could not achieve by indirection that which had already been denied directly. Obviously, this case did not involve the question presented here and simply is not relevant.

The appellant also relies upon some language in the dissenting opinion in *In re A. M. Townson & Co.,* 283 F.2d. 449, 461 (3rd Cir. 1960) (Appellant's Opening Brief at 17). Obviously, the dissenting opinion can not be considered the *ratio decidendi* of the case. Furthermore, that case did not involve receiver's Certificates. Judge Kalodner, in the opinion quoted by the appellant, merely stated that he believed the majority was in error in according a bank a first priority status under Section 64 a (1) by permitting the bank to set off an overdraft in one receiver's account against the deposits in another receiver's account since borrowing by the receiver was not authorized by the bankrupcty court and accordingly could not be considered a charge upon the bankruptcy estate.

The policy of Section 64 a (1) of the Bankruptcy Act is in part to promote the efficient administration of the superseding bankruptcy. Section 64 a (1) was amended to cure the undesirable result achieved in the *In re Columbia Ribbon Co.,* case, supra, p. 9, where costs of administration incurred in the superseding and superseded proceeding were treated on parity. It was the legislative judgment that unless the expenses and costs of administration in the superseding proceeding were accorded a superpriority, there was a substantial risk that such administrations would break down since the trustee could not be assured that the costs incurred by him would be paid ahead of prior unpaid costs and expenses. The amendment of Section 64 a (1) eliminated this problem by providing for a superpriority

for the costs incurred in the superseding proceeding. See 3, Collier, Bankruptcy ¶ 64.01 [3.2] at p. 2058 (14th ed. 1967). Section 64 a (1) does not eliminate or affect priorities previously accorded under Section 344 except for the superpriority accorded the costs incurred in a superseding bankruptcy. The petitioner has not cited any authority which holds that Section 64 eliminates or affects such priorities previously acquired under Section 344. *In re Delaware Hosiery Mills,* supra, p. 10, the court suggested that it was within the equitable powers of the bankruptcy court to grant such priorities. 202 F.2d at 953, fn. 6. See also *In re Bridgeford Co.,* 237 F.2d 182 (9th Cir. 1956) where the court recognized inferentially that receiver's Certificates may provide for and be accorded priority over other expenses of administration.

It is consistent with the policy underlying Section 64 a (1) to respect and give effect to the priorities granted pursuant to Section 344 to Receiver's Certificates over other costs incurred in a superseded Chapter XI proceeding. To do otherwise might impede efficient and effective administration during the Chapter XI proceeding. If creditors furnishing services and other consideration to the debtor in exchange for Receiver's Certificates can not be assured that the priority accorded them in their Certificates pursuant to Section 344 will be respected should bankruptcy follow, then it is likely that such creditors may not furnish such consideration when it is critically needed by the debtor.[2]

---

2. The District Court recognized the equitable and common sense reasons for according the certificates the priority to which they were expressly entitled. The Court said:

> The action of the Referee in withdrawing the priority awarded to the certificates of indebtedness was erroneous and their priority should be reinstated. To hold otherwise would deal a serious blow to the effectiveness and utilization of certificates of indebtedness. It is not unreasonable to assume that

An analogous situation was discussed in *Nicholas v. United States,* 384 U.S. 678, 86 S. Ct. 1674 (1966). The question presented was whether a trustee in a superseding bankruptcy was liable for interest and penalties on federal taxes incurred by a debtor in possession during a Chapter XI proceeding. The Referee allowed the government's claim for the principal of the taxes but disallowed the claims for penalties and interest. On appeal, the Supreme Court held that interest would be allowed on the taxes incurred during the Chapter XI proceeding for the period prior to the filing of the petition in bankruptcy, stating:

> The allowance of interest on Chapter XI debts until the filing of a petition in bankruptcy promotes the availability of capital to a debtor in possession and enhances the likelihood of achieving the goal of the proceeding, the ultimate rehabilitation of the debtor. Disallow-

---

Southwest and Producers, in accepting the certificates and loaning the money to the debtor, placed reliance on the provisions of the certificates awarding them a priority over other costs of administration. The Referee obviously thought that such a priority was equitable at the time he issued the certificates. The only change in circumstances from the time the certificates were issued to the date of the final order in bankruptcy was that the arrangement attempt had failed, and there were insufficient funds in the bankrupt's estate to meet all of the costs of administration. The Referee does not allege that the priority in the certificates was obtained by fraud or that the holders thereof have acted in bad faith. The Referee obviously expected the arrangement proceedings to work, and that the farming operations would net the estate considerable funds. The mere failure of this to happen and the resultant lack of funds to cover the administrative costs of the proceedings is not, in and of itself, grounds upon which one might, under his equitable powers, retract a previous guarantee of priority. This is, in fact, one of the very contingencies that the provisions as to priority would seem to guard against. To retract a priority which was granted under the equitable powers of the court because of the subsequent occurrence of events which accord the priority a meaningful status in the proceedings is to deny equity to the holders of the certificates, and render the initial power to award priorities a meaningless function. R. 201-202.

> ance of interest on Chapter XI debts might seriously hinder the availability of such funds and might in many cases foreclose the prospect of the debtor's recovery. 384 U.S. at 687, 86 S. Ct. at 1681.

The same reasons and policy considerations apply here: unless the recipients of Receiver's Certificates can be assured that the priority granted in those Certificates will be respected, the availability of capital to the debtor will be severely restricted and the likelihood of achieving the goal of the proceeding will similarly be impaired.

The District Court recognized that, just as Section 64 a (1) provided an exception to the parity treatment in according priority to costs of administration in a superseding bankruptcy, so also did Congress allow for a special treatment of Receiver's Certificates of Indebtedness as set forth in Section 344 of the Act. However, even if the priority treatment accorded the Receiver's Certificates was not expressly authorized by statute, it would be within the equitable powers of the Bankruptcy Court to accord such priority. Cf. *In re Miracle Mart, Inc.* (3rd Cir. June 3, 1968) C.C.H. Bankruptcy Reports ¶62,784 at p. 72,388. In that case the referee authorized the rejection of the leases after the expiration of this six month period for filing claims, and he allowed the appellants ten days within which to file their claims arising out of the rejection of the leases. At that time, Section 355 of the Bankruptcy Act provided that claims would be allowed only if filed within six months after the first date set for the first meeting of creditors. On appeal, the Court of Appeals rejected the contention that the Bankruptcy Court did not have the power to mitigate Section 355 and held that resort to the equitable powers of a Bankruptcy Court was justified.

The appellant places emphasis upon the language of Section 344 which refers to "existing obligations". Although the appellant does not so state, we assume that it is arguing that under Section 344, the Bankruptcy Court is without power to authorize Receiver's Certificates with prospective priority over subsequent costs of administration incurred in the Chapter XI proceeding. This is a strained and artificial construction of Section 344. That language does not preclude granting priority to the Certificates over subsequent costs of administration. It seems clear that Congress expressly provided that the Referee could authorize priority over existing obligations since that was an extraordinary power and would affect creditors extending credit during the Chapter XI proceeding who, absent the language in Section 344, would do so without notice that their rights could be subsequently altered. Obviously, it was not necessary to expressly confer authority upon the Referee to authorize Certificates with priority over subsequent obligations since subsequent creditors would extend credit with notice that Receiver's Certificates had been issued with express priority. Accordingly, the appellant's contention is totally without merit. The appellant does not assert that it had no notice of the claims of Producers and Southwest to priority nor could it do so now. There are no equitable considerations which require that these holders of Receiver's Certificates be deprived of the priority to which they are otherwise entitled.

CONCLUSION

It is submitted that the law and the evidence support the opinion and order of the District Court and the amended findings of fact, conclusions of law and order of the Referee entered in accordance therewith and the order of the District Court should be affirmed.

Respectfully submitted,

FENNEMORE, CRAIG, VON AMMON, MCCLENNEN & UDALL

By ROBERT H. CARLYN
411 North Central Avenue, Suite 900
Phoenix, Arizona 85004

Attorneys for appellee Southwest Forest Industries, Inc.

RAWLINS, ELLIS, BURRUS & KIEWIT

By WILLIAM D. BAKER
733 Security Building
Phoenix, Arizona 85004

Attorneys for appellee Producers Cotton Oil Co.